No. 22,483

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

ROY O. DISNEY and EDNA F. DISNEY,

Plaintiffs

v.

UNITED STATES OF AMERICA,

Defendant-Appellant

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE CENTRAL DISTRICT OF CALIFORNIA

REPLY BRIEF FOR THE APPELLANT

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In our opening brief we contended that the amounts paid to the taxpayer to reimburse him for his wife's travel expenses were includable in his gross income (Br. 9-14); we contended further that, with respect to the taxpayer, those expenses were non-deductible personal expenses, not deductible business expenses (Br. 14-24). In their brief, the taxpayers have challenged both contentions.

I

THE AMOUNTS IN QUESTION PAID TO TAXPAYERS ARE INCLUDABLE IN THEIR GROSS INCOME

A. General principles

It is well established that amounts paid to taxpayers by their employers to defray travel or similar expenses are includable in

gross income; then, the expense is deductible if, but only if, it meets the specific statutory requirements therefor, a matter of policy for Congress to determine. United States v. Woodall, 255 F. 2d 370, 373 (C. A. 10th, 1958), certiorari denied, 358 U.S. 824; accord, Koons v. United States, 315 F. 2d 542 (C. A. 9th, 1963); see also United States v. Correll, 389 U.S. 299 (1967); James v. United States, 308 F. 2d 204 (C. A. 9th, 1962). This traditional approach to such problems is a practical necessity, for a serious erosion of the tax base would result if taxpayers could exclude a reimbursement from gross income at the outset on the vague ground that the reimbursed expense was incurred for the employer's benefit--which is as true of taxable compensation as it is of the employer's other expenses[1]--without determining whether the expense satisfies the requirements of the relevant deduction provisions. Further, contrary to the District Court's apparent view (I-R. 149), to be within Section 61(a) a receipt need not be compensation for services, for that is only one example of gross income (Section 61(a)(1)) and the statute is "not limited to" the examples set forth therein. In

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[1] As pointed out in Van Rosen v. Commissioner, 17 T.C. 834, 838 (1951), salaries would not be provided "unless the employer regarded the expenditures as being for his convenience" or benefit. Accordingly, contrary to taxpayer's contention here, simply that the corporation may have decided that its business benefited from the expenses in question does not determine whether or not their payment constituted additional compensation to taxpayers. The clearest example of an error (and confusion) in this respect is that made in McDonell v. Commissioner, decided January 31, 1967 (P-H Memo T.C., par. 67,018), where the court states, as a reason for finding that the amounts paid to taxpayers were not additional compensation for services rendered, that the trips was (p. 129) "no different from any other business trip requiring their services--including Jeanne

(continued)

the absence of the applicability of a specific statutory exclusion from gross income, the amounts in question received by the taxpayers are includable in their gross income. (See our opening brief, pp. 10-12.) Taxpayer's attempt, hereinafter discussed, to avoid the broad scope of Section 61(a) is, we submit, without substantial merit.

B. The reimbursements constitute additional compensation to the taxpayer

1. The taxpayer's primary contention (Br. 10-11, 13-28) is that the District Court was correct in holding (I-R. 149) that the amounts paid to him to reimburse him for his wife's travel expenses were (Br. 11) "not compensatory" and, therefore, did not constitute gross income. It may be true that the amounts paid for Mrs. Disney's expenses by Walt Disney Productions did not constitute compensation to her, for it is doubtful that she performed any substantial services.[2] But, since the amounts paid to the taxpayer defrayed his expenses of taking his wife with him on the trips, and he is an employee, such amounts constitute additional compensation to him; thus, the only

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1/ (continued)
[the wife] whose duties were substantial." To the contrary, that she performed services demonstrates the compensatory nature of the payments and probably also allows her an offsetting business expense deduction. (See our opening brief, p. 13.)

[2] It is as true here as it was in Heidl v. Commissioner, decided January 17, 1964 (P-H Memo T.C., par. 64,007), p. 31, that "Whatever contacts she had with * * * [the corporate business], either while she was at home or during the trip, were apparently not considered sufficiently valuable to cause the payment to her of any compensation for services." Accordingly, taxpayer does not contend that his wife can deduct those expenses as her ordinary and necessary business expenses. Instead, he contends (Br. 28-34) that those expenses are his own business expenses, a contention discussed infra, Part II.

question is whether he may deduct the expenses. See Silverman v. Commissioner, 253 F. 2d 849, 852-853 (C. A. 3d, 1958); Patterson v. Thomas, 289 F. 2d 108, 112 (C. A. 5th, 1961).

2. That Congress intended gross income to include the reimbursement of travel expenses is implicit in Section 62(2)(A) (B), which allow, respectively, deductions from gross income for specified business expenses of an employee for which he has been reimbursed by his employer and for business traveling expenses. Clearly, if the reimbursement of such travel expenses did not constitute gross income, there would be no occasion to permit such deductions.

3. To support his contention that the amounts in question are not includable in gross income, taxpayer relies (Br. 18-19) on Section 1.162-17(b)(1) of the Treasury Regulations on Income Tax (1954 Code), Appendix, *infra*, and Lickert v. Commissioner, decided February 28, 1964 (P-H Memo T.C., par. 64,047), which was concerned with that regulation. Contrary to taxpayer's apparent assumption, however, Section 1.162-17 of the Regulations is not a gross income regulation but a business *deduction* regulation. This is evident from its designation; it is issued under Section 162, the business expense deduction provision, not under Section 61(a), the gross income provision. Further, it applies only to (Sec. 1.162-17(a) of the Regulations, Appendix, *infra*)--

> those expenses which are ordinary and necessary in the conduct of the taxpayer's business and are directly attributable to such business. The term does not include nondeductible personal, living or family expenses.

The purpose of this regulatory provision is to provide rules for the substantiation of such expenses when claimed as deductions. See also Section 274[3/] and the Regulations issued thereunder. This is clear from the Lickert case, supra, for the court, in determining whether or not the requirements of the regulation had been satisfied, correctly stated that (p. 416) "The primary issue is whether petitioners are entitled to deduct * * * travel and entertainment expenses for which petitioner was reimbursed by his employer." (Emphasis supplied.) The court held (p. 417) that the taxpayer had "done about everything required by * * * [the] regulations * * * in reporting and substantiating his reimbursed expenses. Sec. 1.162-17 (b)(1) Income Tax Regs., * * * ."

In Section 1.162-17, then, the Commissioner has provided, for purposes of administrative convenience both to himself and to taxpayers, that as to business expenses deductible under the statute, if the employer reimburses the employee therefor pursuant to a system under which the employee adequately accounts to the employer for the expenses, the Commissioner does not require that the employee go through the formality of first including the reimbursement in gross income on his return and then deducting it. Instead, he simply indicates on the return that he has received items from his employer as reimbursements pursuant to such a system. The significant point here is that Section 1.162-17 corroborates the long-standing rule that such reimbursements are necessarily gross income items.

[3/] Section 274 was added to the 1954 Code by Section 4(a), Revenue Act of 1962, P. L. 87-834, 76 Stat. 960.

Therefore, it is appropriate to provide regulatory rules respecting the substantiation of the reimbursed expenses for deduction purposes. The regulation, then, offers no support to taxpayer's contention that a reimbursement of a travel expense is not conceptually a gross income item within Section 61(a). To the contrary, it stands for exactly the opposite proposition, even where the expense is incurred (Sec. 1.162-17 (b)(1)) "solely for the benefit of * * * [the] employer * * * ." Accordingly, insofar as the District Court may have relied (I-R. 142) on Section 1.162-17 of the Regulations for its holding that the amounts paid to taxpayers were non-compensatory items excludable from gross income (I-R. 149), it erred. Jenkins v. Commissioner, decided December 27, 1967 (P-H Memo T.C., par. 67,257) (pp. 1462-1463).

4. None of the cases cited by taxpayer (Br. 14-15) involve either the concept of gross income or the concept of any exclusion therefrom. Instead, they are all concerned with whether or not gross income should be reduced by certain expenses to arrive at taxable income, which, in each case, depended on whether the expense was in fact incurred and (or) whether it was deductible as an ordinary and necessary business expense.[4]

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[4] For example, in Cullinan v. Commissioner, 5 B.T.A. 996 (1927), the taxpayer, traveling for a corporation on business, incurred travel expenses in excess of his reimbursements. On his return, he attached a statement that the payments were reimbursements for such expenses and did not include the amounts in income or claim deductions therefor. The court held that the traveling expenses exceeded the reimbursements and it was, therefore, error to add the reimbursements to (p. 999) "the reported net income." (Emphasis supplied.)

In Chianese v. Commissioner, decided June 30, 1950 (P-H Memo T.C., par. 50,201), the Commissioner disallowed all expense deductions claimed on the return (which were excessive) and then allowed the taxpayers \$6 per day for foreign travel expense deductions, thereby including \$2 of the \$8 per day reimbursement as net gain. The court

(continued)

5. Taxpayer also relies (Br. 15-17) on the rule embodied in Rev. Rul. 54-429, 1954-2 Cum. Bull. 53, that reimbursements for certain direct moving expenses where the employee is moved primarily for the convenience of the employer are excludable from gross income. See also Cavanagh v. Commissioner, 36 T.C. 300 (1961); Starr v. Commissioner, 46 T.C. 743 (1966), pending on appeal (C. A. 10th - No. 9370). The ruling and the cases interpreting it are limited to moving, not traveling, expenses. The apparent rationale for the ruling is that the employer, by transporting the employee from one business location to another at his own expense and for the benefit of his own business, is, in effect, simply (Van Rosen v. Commissioner, 17 T.C. 834, 838 (1951))--

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4/ (continued)
found (p. 639) that the taxpayer's "actual expenses while on foreign travel * * * were $8.00 per day" and, therefore, that the Commissioner erred in his determination.

In Sanitary Farms Dairy, Inc. v. Commissioner, 25 T.C. 463, 467 (1955), again only a deduction question was involved, the court stating that "the cost of a big game hunt in Africa does not sound like an ordinary and necessary expense of a dairy business * * * but the evidence in this case shows * * * that it was * * * ."

In Gray v. Commissioner, 10 T.C. 590, 596-597 (1948), the only question was whether or not the expense had in fact been incurred and, if so, whether it had been incurred in business activity and business travel.

In Siegfried v. United States (N.D. Okla.), decided May 26, 1955 (48 A.F.T.R. 1821), the only question involved was the substantiation of the alleged expense items, reimbursement of which was not reported on the income tax returns, nor were deductions claimed therefor. The court held that the portion of the reimbursement in controversy was not includable in taxable income.

> furnishing * * * a place to work and * * * supplying * * * the tools and machinery with which to work. The fact that certain personal wants and needs of the employee were satisfied was plainly secondary and incidental to the employment.

While it may be that it would not have been unreasonable for the Commissioner to refuse to grant favorable tax treatment for such moving expense items, there certainly is no basis for attempting to extend that ruling to other types of expense reimbursements, such as the amounts paid for the wife's travel expenses involved here. Cf. England v. United States, 345 F. 2d 414 (C. A. 7th, 1965), certiorari denied, 382 U.S. 986, reversing 226 F. Supp. 762, 766 (S.D. Ill., 1964); Ritter v. United States, 393 F. 2d 823 (Ct. Cl., 1968), petition for certiorari filed July 18, 1968 (37 U.S. Law Week 3049).

6. The other rulings relied on by the taxpayer (Br. 17-18) involve the reimbursement of expenses incurred in carrying out voluntary, gratuitous services in a non-business context for religious, educational and medical organizations. Under those particular circumstances, the Commissioner ruled that the reimbursements did not constitute gross income. Those situations bear no resemblance to that involved here where the taxpayer's wife incurred expenses in traveling with her husband on trips that were admittedly business trips for him, for which expenses she was reimbursed by his employer. In the situations covered by the rulings, unlike the situation here,

there was no employee who benefited by his employer's payment of the expenses in question.

7. While the cases relied on by taxpayer (Br. 20-23) are distinguishable on their facts from the instant case, for the reasons stated above and in our opening brief (pp. 9-14), we think they were erroneously decided insofar as they hold that amounts paid to taxpayers to reimburse them for traveling expenses are not includable in gross income. See Jenkins v. Commissioner, decided December 27, 1967 (P-H Memo T.C., par. 67,257); cf. Rieley v. Commissioner, decided March 31, 1964 (P-H Memo T.C., par. 64,066), in which the Tax Court expressly declined to follow Allenberg Cotton Co. v. United States (W.D. Tenn.), decided December 2, 1960 (7 A.F.T.R. 2d 368); see also Zubrod v. Commissioner, decided October 19, 1967 (P-H Memo T.C., par. 67,204).

8. In the light of the foregoing discussion, the taxpayer errs when he argues (Br. 25) that the reimbursements of expenses incurred on business, as distinguished from pleasure, trips are excludable ab initio from gross income. The only specific exclusion rule that he has relied on--namely, the reimbursement of moving expenses incurred primarily for the benefit of the employer--is inapplicable here because we are not here concerned with moving expenses and, moreover, the District Court here did not find that the expenses in question were incurred primarily for the benefit of the employer. (I-R. 144-151.) Instead, the District Court, like the taxpayer here, mistakenly relied on Section 1.162-17 of the Regulations

for holding that the expenses in question were excludable from (Section 61(a)) "gross income," whereas that regulatory provision is concerned solely with the substantiation requirements of deductible business expenses.

II

THE WIFE'S TRAVEL EXPENSES ARE NOT DEDUCTIBLE

A. <u>The taxpayer's wife performed only incidental services not constituting actual business activities</u>

In light of the District Court's findings (I-R. 147; see also I-R. 138-139), with which the taxpayer apparently agrees (Br. 5, 7), it is apparently not disputed that his wife's activities on his business trips, aside from her sightseeing and shopping, were primarily wifely and social--that is, she participated in entertaining and attended business functions with her husband and generally helped her husband in any way that a wife under such circumstances might be expected to do.[5] (See our opening brief, pp. 4-6.) As such, the expenses incurred in carrying on such activities are not deductible under Section 162(a) as interpreted by the applicable regulatory provision and a long line of cases involving similar activities by taxpayers' wives on comparable business trips. Sec. 1.162-2(c) of the Treasury Regulations on Income Tax (1954 Code);

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[5] We do not agree, however, with taxpayer's statement (Br. 5) that his wife "makes arrangements for different functions."

Alabama-Georgia Syrup Co. v. Commissioner, 36 T.C. 747, 753-755, 768-769 (1961), reversed on another issue sub nom. Whitfield v. Commissioner, 311 F. 2d 640 (C. A. 5th, 1962); Campbell v. Commissioner, decided June 8, 1961 (P-H Memo T.C., par. 61,166, pp. 927-928; see also pp. 909-911, 922-923); Kloppenburg v. United States (S.D. Ill.), decided November 1, 1965 (17 A.F.T.R. 2d 507, 508)[6/]; Heidl v. Commissioner, decided January 17, 1964 (P-H Memo T.C., par. 64,007); Rieley v. Commissioner, decided March 31, 1964 (P-H Memo T.C., par. 64,066); Zubrod v. Commissioner, decided October 19, 1967 (P-H Memo T.C., par. 67,204) (and see the cases cited in our opening brief, pp. 18-19). But cf. Warwick v. United States, 236 F. Supp. 761 (E.D. Va., 1964); Gotcher v. United States, 259 F. Supp. 340 (E.D. Tex., 1966).

In the cases cited above disallowing the claimed deduction, the wives helped their husbands entertain in a business context, performed incidental secretarial work and generally assisted their

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[6/] As stated in the Kloppenburg case, supra, p. 508:

> [The wife's] * * * expenses would be incurred for a bona fide business purpose only if she was actively engaged in the plaintiff's business and her presence was necessary * * * . The assistance that a wife who is interested in her husband's business affairs would normally provide her husband does not itself permit the deduction of her expenses * * * .

husbands in any way they could just as the taxpayer's wife did in the instant case. But, since such activities are the normal types of activities that a wife might be reasonably expected to carry on when accompanying her husband on business trips, they do not qualify the wife's expenses as deductible business expenses. Nothing in the record in the instant case distinguishes it from the cases cited, <u>supra</u>, in which it was held, in accord with Section 1.162-2 (c) of the Regulations, that comparable expenses were not deductible.

B. <u>That taxpayer's wife may have enhanced the corporate image does not make the expenses deductible</u>

The taxpayer attempts to distinguish the instant case from the cases in which the deduction was not permitted on the ground that the corporate management believed the wife's presence on the taxpayer's business trips tended to enhance the corporate family-entertainment-and-product image. A comparable allegation, however, can be made with respect to many other types of businesses in addition to that involving family-type entertainment and products. But looking at that category alone, the total number of items merchandised by Walt Disney Productions, for example, was estimated to be 5,000, including (I-R. 37) "games, toys, boys' clothing, dresses, stuffed dolls, cutlery, sports equipment, lamps, ceramics, furniture and costume jewelry * * * [and] a wide variety of books and magazines ranging from comic strips and comic books to hard-bound, beautifully illustrated publications." Thus, if taxpayer's position were to be

adopted, many corporations might find their images enhanced, for a variety of reasons growing out of their particular types of business activity, by having the wives of their executives accompany them on business trips. In short, the so-called distinction urged by the taxpayer is not a distinction at all for, if adopted, it would cover a great portion--if not substantially all--of American industry involved in the production or selling of merchandise, thereby making the regulation a practical nullity.

Moreover, while we seriously doubt that the primary purpose of having the taxpayer's wife accompany him on his business trips was to enhance the "image" of the corporation (I-R. 147) "as a disseminator of family entertainment," even if true, it tends to corroborate the Government's position that the wife was limited in her activities to wifely and social activities--"incidental" activities within the meaning of the regulation. The desired family image would preclude her from carrying on business activities as a business partner or associate. That is, unlike the wives involved in Thomas v. Commissioner, decided March 14, 1939 (P-H Memo B.T.A., par. 39,112); McDonell v. Commissioner, decided January 31, 1967 (P-H Memo T.C., par. 67,018); and Duncan v. Bookwalter, 216 F. Supp. 301 (W.D. Mo., 1963), she could not have assumed the role of an active professional business woman; instead, the family image would require that she be herself--a general helpmate to her husband, a gracious wife and hostess. While this may entitle the corporation to a deduction, it precludes a deduction for the taxpayer pursuant to Section 162(a)

and Section 1.162-2(c) of the Regulations.

C. That the corporation may be entitled to deduct the amounts paid to the taxpayer to cover his wife's travel expenses does not make them deductible by the taxpayer

As clearly indicated in Silverman v. Commissioner, 253 F. 2d 849, 852 (C. A. 3d, 1958), and Patterson v. Thomas, 289 F. 2d 108, 112-113 (C. A. 5th, 1961), that a corporation may find it useful to its business to have its executives accompanied by their wives on business trips--for example, to enable them to function more effectively--does not mean that the executives may deduct their wives' travel expenses as expenses incurred by them in the pursuit of their business activities on behalf of the corporation. The question in such cases, contrary to taxpayer's view (Br. 34), is whether the taxpayer would be entitled to deduct those expenses if he were paying for them himself (Dean v. Commissioner, 35 T.C. 1083, 1089-1090 (1961)), which would depend on whether the wife's activities constituted actual business endeavors. Here, viewed from that perspective, the expenses in question are clearly non-deductible personal expenses. While the wife's activities indirectly aided the taxpayer in carrying on his business activities (including the enhancement of the corporate image), they remain, nevertheless, only incidental thereto within the meaning of the regulation and the cases cited, *supra*, Part II, B.

See also Steinhort v. Commissioner, 335 F. 2d 496 (C. A. 5th, 1964); Smith v. Warren, 388 F. 2d 671 (C. A. 9th, 1968).

By Section 1.162-2(c) of the Regulations, promulgated in 1958,[7/] the Commissioner has undertaken to draw a rule of practical administration distinguishing between personal and business expenses in an area involving limitless factual variations where many different lines could be drawn by individual courts. It achieves certainty and essential equality of tax treatment among similarly situated taxpayers. Accordingly, it is entitled to respect. United States v. Correll, 389 U.S. 299, 306-307 (1967); Steinhort v. Commissioner, supra. That rule requires that the expenses in question be characterized as personal, non-deductible expenses, regardless of how the taxpayer's employer views them for its own tax purposes. See Adelson v. United States, 342 F. 2d 332, 335 (C. A. 9th, 1965).

[7/] See T.D. 6291, 1958-1 Cum. Bull. 63.

CONCLUSION

For the reasons stated above and in our opening brief, the decision of the District Court is erroneous and should be reversed.

Respectfully submitted,

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APPENDIX

Treasury Regulations on Income Tax (1954 Code):

§ 1.162-17 Reporting and substantiation of certain business expenses of employees.

(a) Introductory. The purpose of the regulations in this section is to provide rules for the reporting of information on income tax returns by taxpayers who pay or incur ordinary and necessary business expenses in connection with the performance of services as an employee and to furnish guidance as to the type of records which will be useful in compiling such information and in its substantiation, if required. The rules prescribed in this section do not apply to expenses paid or incurred for incidentals, such as office supplies for the employer or local transportation in connection with an errand. Employees incurring such incidental expenses are not required to provide substantiation for such alounts. The term "ordinary and necessary business expenses" means only those expenses which are ordinary and necessary in the conduct of the taxpayer's business and are directly attributable to such business. The term does not include nondeductible personal, living or family expenses.

(b) Expenses for which the employee is required to account to his employer--(1) Reimbursements equal to expenses. The employee need not report on his tax return (either itemized or in total amount) (expenses for travel, transportation, entertainment, and similar purposes paid or incurred by him solely for the benefit of his employer for which he is required to account and does account to his employer and which are charged directly or indirectly to the employer (for example, through credit cards) or for which the employee is paid through advances, reimbursements, and charges is equal to such expenses. In such a case the taxpayer need only state in his return that the total of amounts charged directly or indirectly to his employer through credit cards or otherwise and received from the employer as advances or reimbursements did not exceed the ordinary and necessary business expenses paid or incurred by the employee.

*   *   *

(4) To "account" to his employer as used in this section means to submit an expense account or other required written statement to the employer showing the business nature and the amount of all the employee's expenses (including those charged directly or indirectly to the employer through credit cards or otherwise) broken down into such broad categories as transportation, meals and lodging while away from home overnight, entertainment expenses, and other business expenses. For this purpose, the Commissioner in his discretion may approve reasonable business practices under which mileage, per diem in lieu of subsistence, and similar allowances providing for ordinary and necessary business expenses in accordance with a fixed scale may be regarded as equivalent to an accounting to the employer.

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(26 C.F.R., Sec. 1.162-17.)